United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

ORIGINAL

74-2582

United States Court of Appeals
For the Second Circuit

ROSALIND FOGEL, *et ano.*,
Plaintiffs-Appellants,
versus
GEORGE A. CHESTNUTT, JR., *et al.*,
Defendants-Appellees.

BRIEF FOR PLAINTIFFS-APPELLANTS AND SUPPLEMENTAL APPENDIX

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BRIEF FOR PLAINTIFFS-APPELLANTS

This stockholders' derivative action was brought on behalf of a registered mutual fund against its directors and its investment adviser to recover for breaches of defendants' duties under the Investment Company Act (the "Act") and the common law. The plaintiffs appeal from the judgment of the District Court for the Southern District of New York (Wyatt, J.) dismissing the action after a trial to the Court without jury.

The decision below (324a et seq.) is not yet officially reported.

The Question Presented

The appeal presents this question:

> Did defendants' "give-up" and "reciprocal" practices - described below - and their failure to recapture brokerage commissions for the Fund violate their statutory and non-statutory duties so as to give plaintiffs a right to relief on behalf of the Fund?

The Court below decided this question in defendants' favor by finding that one method of brokerage recapture was not possible and that another method, though possible, was against public policy. To reach these results, the Court overrode the testimony of senior officials of the National Association of Securities Dealers ("NASD") and the PBW Stock Exchange, substituted its erroneous interpretation of the rules of a self-regulatory agency for that of the officer responsible for their interpretation and enforcement, and precluded application of clear and prevailing Exchange

policy by a complete misconception as to the requirements of public policy.

Moreover, the District Court ignored the provisions of an investment advisory agreement which forbade the use of give-ups and reciprocals even if their recapture were not possible.

Statement of the Case

Jurisdiction and Proceedings

The action was commenced on July 11, 1968 (1a). The District Court's jurisdiction was invoked under the Investment Company Act (5a). The trial of the action was limited to the issue of defendants' liability; questions regarding the nature and amount of any recovery were reserved (325a).

The jurisdiction of this Court rests on 28 U.S.C. § 1291. The judgment below was entered November 6, 1974 (4a). Plaintiffs' notice of appeal was filed December 2, 1974 (4a).

The Parties

Plaintiffs-Appellants have been shareholders of defendant American Investors Fund, Inc. ("the Fund") since 1963 (5a). The Fund, a New York corporation, is a no-load mutual fund registered with the Securities and Exchange Commission under the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 et seq. (the "Act"). As of December 31, 1968 the assets of the Fund were over $342,000,000 and it had 142,000 shareholders (Trial Exhibit 16).

Defendant Chestnutt Corporation, the Fund's manager and investment adviser ("Management Co."), is a Connecticut corporation. On July 19, 1966, Management Co. acquired the assets of defendant American Investors Corporation, the Fund's previous manager, subject to its liabilities. Management Co. and its predecessor (herein referred to collectively as "Management Co.") had the same officers, directors and stockholders, and each stockholder held the same proportionate interest in both corporations (26a).

The stockholders of Management Co. included defendants George A. Chestnutt, Jr., Stanley L. Sabel, Warren K. Greene and John Currier. Clendon H. Lee, special counsel to the Fund and to Management Co., was also a shareholder of Management Co. These defendants and Mr. Lee* had the following approximate percentage interests in the voting stock of Management Co.:

George A. Chestnutt, Jr.	47%
Stanley L. Sabel	16%
John Currier	2%
Clendon H. Lee	1%
Warren K. Greene	0.4%

(26a, 27a).

The activities complained of in this action occurred from January 1, 1965 to the present. At all times during that period the officers and executive personnel of the Fund and

*Mr. Lee's interest is indirect since these shares are held by his wife.

Management Co. were closely interlocked. Thus, defendant George A. Chestnutt, Jr., the founder of the Fund, was its president and director. He was also president and a director of Management Co. (27a). Defendant Chestnutt was the principal force in both the Management Co. (where his economic interest lay) and in the Fund.

Defendant Stanley L. Sabel was senior vice president, secretary and a director of the Fund. He was also vice president, secretary, general counsel and a director of Managment Co. At the same time, the firm of Sutton, Sabel & Schupp, in which defendant Sabel was a partner, was legal counsel to the Fund. In 1971 defendant Sabel resigned all offices with the Fund, except his directorship (27a).

Defendant Warren K. Greene was vice president and director of the Fund, and vice president of Management Co. (id).

During the relevant time period, the Fund had a board consisting of eight (or, at times, seven) directors.

The Court below found that at all times at least 50% of the Fund's directors had an economic interest in Management Co. and during much of the time more than 50% of the Fund's directors had such an interest (328a, 329a).

The Fund had no independent officers. All of its officers were also stockholders, officers, directors and/or employees of Management Co. Their compensation was paid by Management Co.; the Fund paid them nothing (159a, 175a). In any conflict of interests, therefore, their allegiance was likely to be to their paymaster, Management Co., not the Fund. All the Fund's other employees likewise received their compensation from Management Co. (id.).

Clendon H. Lee was counsel to the Fund and its directors. He was also special counsel to, and a director of, Management Co., and is counsel for all the defendants in this action other than the Fund (29a).

Thus, all officers and employees of the Fund and counsel to the Fund were under dual allegiance to Management

Co. The Fund's "affiliated" directors (i.e. directors of the Fund who were also officers, directors and/or stockholders of Management Co.) were the principal officers of the Fund. They were in a clear conflict of interest.

The Court below recognized the fundamental conflict of interest between the Fund and Management Co.:

> "The Adviser [Management Co.] and those interested in it - chiefly George [George A. Chestnutt, Jr.] - managed and controlled the Fund. If there were a conflict in interest between the Fund and the Adviser, the economic interest of the chief personalities would be with the Adviser." (335a).

Management Co. acted as the Fund's manager and investment adviser under an investment advisory agreement. The agreement provided for the payment by the Fund to Management Co. of an annual advisory fee of .8% of the first $50 million of the Fund's net assets, plus smaller percentages on assets in excess of $50 million (28a). The advisory fee paid to Management Co. for the years 1964 through December 31, 1970, were as follows:

1964	$ 187,000
1965	337,000
1966	529,000
1967	1,087,000
1968	1,464,000
1969	1,557,000
1970	1,175,000

(id.).

Give-Ups and Reciprocals

Plaintiffs' charges arise from defendant's give-up and reciprocal practices.

The Fund bought and sold large amounts of portfolio securities on national securities exchanges, investing the pooled assets of its shareholders. These transactions were subject to the minimum commission rates fixed by the exchanges. Since the Fund and other institutions frequently executed transactions of substantial size, the minimum commissions were often considerably in excess of those which would fairly compensate a broker for his services (SEC, Public Policy Implications of Investment Company Growth, H. Rep. No. 2337, 89th Cong., 2d Sess. pp. 162-163 (1966) ("PPI", Trial Exhibit 4).

The brokerage commissions generated by the Fund's transactions were substantial (see the chart set forth *infra* at p. 12.

Under exchange rules, brokers were permitted to share their commissions with other brokers. Pursuant to those rules, brokers executing institutional orders would, at the direction of those placing the orders, "give up" large portions of their commissions to other brokers. So attractive was the Fund's portfolio business to brokers who executed it, that they were willing to give up a major portion of their commissions, as much as 75%, to other brokers (84a, 85a, 253a, 254a). At the behest of officers and employees of Management Co., brokers were directed to give up a portion of their commissions to other brokers who assisted in the sale of Fund shares (84a). Such give-ups continued until give-ups were abolished by the stock exchanges on December 5, 1968 (176a, 177a).

In other instances, brokers who assisted in the sale of Fund shares executed transactions themselves. As a reward

for selling Fund shares, these brokers were allowed to keep all the Fund commissions they received despite the fact that they were prepared to give up a portion of these commissions at the direction of the officers and employees of Management Co. (92a-95a). This practice of rewarding brokers for selling Fund shares by giving them commission business of the Fund is commonly referred to as reciprocals. Reciprocals were utilized by the defendants until they were abolished by the NASD on May 25, 1973, effective July 15, 1973 (Trial Exhibit 18).

Reciprocals and give-ups were also directed to brokers who supplied research information to Management Co. (176a).

The allocation of the Fund's reciprocals and give-ups was determined by the officers and employees of Management Co., who in the case of give-ups would send letters in the name of the Fund requesting brokers to give up a portion of their commissions to Management Co.'s designees (84a, 85a).

During the years 1965 through 1970, the Fund's brokerage commissions were allocated, in the form of give-ups and reciprocals, as follows:

Year	Total Brokerage Commissions	Allocated To Sales	Allocated To Research
1965	$ 387,000	$ 140,000	$ 247,000
1966	551,668	289,755	261,913
1967	1,995,087	1,059,121	935,966
1968	3,122,160	1,099,703	2,022,457
1969	2,489,281	1,293,222	1,196,059
1970	2,059,234	950,567	1,108,667

(153a, 155a).

The amount of Fund brokerage commissions awarded as give-ups is presently undetermined,* except for the years 1967 and 1968, when $326,120 and $663,095, respectively, was

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* Discovery into the amounts of give-ups was deemed related to the issue of damages and deferred.

awarded (177a).

These reciprocals and give-ups were of great advantage to the Management Co. Its contractual compensation depended, in large measure, on the number of Fund shares sold to the public (44a, 45a). The more Fund shares the public bought, the greater became the asset value of the Fund, and the advisory fees received by the Management Co., which were a percentage of Fund assets managed, grew accordingly. The Management Co. thus had a vital economic interest in encouraging the sale of Fund shares.

However, the Fund was, nominally at least, a no-load Fund. No sales fees are paid to brokers for sales of no-load funds (15 USC § 80a-10(d)(3)). Congress, in according special treatment to no-load funds, did so on the basis that sales of their shares are unsolicited. To that end the statute provides that, unlike other mutual funds which must have at least 40% of their directors free from interest in their advisers, no-load funds need have only one disinterested director, provided that "no sales load is charged" and "no sales or promotion expenses are incurred" by them (15 USC § 80a-10(d)(3) and (5)).

Nevertheless, the Management Co. found it quite desirable to stimulate sales of Fund shares. The volume of these sales depended in substantial part on the efforts of brokers who assisted in the sale of Fund shares by recommending to their customers that they invest in the Fund. The brokers ordinarily would furnish a prospectus (which had been prepared and supplied by Management Co.), prepare the requisite forms and handle the purchase for the customer in much the same way as a dealer would handle the purchase of a load fund (Trial Exhibit 23, pp. 71-73).

Since the Fund did not charge a commission or load on the sale of Fund shares, there was no incentive for brokers to recommend the Fund to their customers. In order to provide this incentive, the Management Co. used the Fund's portfolio brokerage commissions to reward those brokers and dealers who assisted in the sale of Fund shares. It was defendants' practice to award reciprocals* or give-ups amounting to <u>at</u>

*The importance of reciprocals in the retailing of the Fund's shares was demonstrated by the Management Co.'s announcement in the June 6, 1972 Fund proxy statement that it was considering instituting a sales load if reciprocals were abolished (161a).

<u>least</u> 2% of the gross sales of Fund shares produced by a particular broker (92a-95a).

Pursuant to its contract with the Fund, Management Co. was obligated to pay all the expenses relating to the promotion and sale of Fund shares (159a). To the extent these expenses were paid with Fund brokerage commissions, Management Co. was able to reduce its own expenses.

Since give-ups and reciprocals increased the advisory fees paid to Management Co. by enhancing the sale of Fund shares, they constituted tangible benefits to Management Co. These benefits to Management Co. cannot be disputed.

Indeed, at the trial defendants conceded that the growth of the Fund benefited Management Co. by increasing its advisory fees (44a-45a), and that give-ups and reciprocals were used to promote sales and thus contributed

to such growth (160a, 161a).*

The commissions allocated in return for research also benefited Management Co. Management Co. had the obligation under the Investment Advisory Contract to supply investment advice to the Fund. For this it was paid handsomely. By using Fund commissions to obtain research from others, Management Co. produced the investment advice at lesser cost to itself, but at the Fund's expense.

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* The Court below agreed that the use of give-ups and reciprocals did benefit the Management Co. (332a), but found that Fund growth was also beneficial to Fund shareholders because it would reduce expenses proportionally. The benefit to shareholders is infinitesimal, however. This can be illustrated by the effects on an investor with a $5,000 holding in the Fund. As of December 31, 1968 his share of the advisory fee of the $342 million Fund was $24.06 (based upon the fee schedule set forth at 175a). If the Fund were to grow another $30 million, the Management Co. would increase its take by $105,000 annually, but the savings to the investor would be only fifty-one cents per year. On the other hand, a recapture of only $600,000 per year (the commissions paid - at a 2% rate - to stimulate sales of $30 million) would have resulted in a saving of 18 times this amount for the hypothesized investor. Moreover, the growth of the Fund had more serious detrimental effects. PPI pp. 255-57 (Trial Exhibit 4).

Recapture

Recapture of brokerage commissions operated in a simple manner. Mutual funds and other institutions, in addition to paying brokerage commissions, also paid advisory fees to their investment advisers. The stock exchanges placed no minimum on such fees. It became common practice for institutions to direct commissions and give-ups to their investment advisers who would credit the commissions received against the advisory fees otherwise payable. This practice was widespread and expressly permitted by the exchanges and the courts. The exchanges regarded it as quite consistent with their rules, and the SEC found it to be a frequent and acceptable practice:

> "The use of brokerage commissions to pay for investment advisory services is common in the securities industry. Investment advisers who are also broker-dealers often reduce advisory fees charged nonfund clients by a specified portion of the brokerage commissions generated by their nonfund advisory accounts or otherwise take them into account in setting advisory fee rates for non-fund clients." PPI pp. 108-109 (143a, 144a)

Nothing in this practice contravened the anti-rebate rules; for despite the reduction or even the elimination of

the advisory fee, the customer still paid the prescribed minimum commission rates.

There were essentially two avenues available for the channelling of recapturable commissions: NASD membership and exchange membership. A number of regional exchanges permitted NASD members to receive brokerage commissions in the form of give-ups or discounts. PPI p. 173 (147a). Once these commissions were received by an NASD member affiliated with a fund or its adviser, they could be credited against advisory fees, i.e. recaptured (id.).

Certain regional exchanges, notably the PBW Exchange, permitted affiliates of mutual funds to become members. As an introducing broker, the affiliated member could retain a portion of the commission paid on transactions executed for the fund by other exchange members. These commissions could also be credited against advisory fees owed by the fund (pp. infra). Both of these recapture methods received express judicial sanction (pp.55-56infra).

The Issues

The Court below agreed with the plaintiffs that Management Co. controlled the Fund. The District Court also found that Management Co. directed commissions to brokers who sold Fund shares, or who gave research material to the Management Co., or both (335a). Both give-ups and reciprocals were used to accomplish these techniques, and benefited the Management Co. (336a). No recapture was effected for the Fund. The Court held that the defendants were under a duty to recapture brokerage commissions for the Fund, if possible (339a).

However, the Court below found that recapture was not available for the Fund. It held that NASD membership for a subsidiary of the Fund or Management Co. was not legally permissible. And it held that recapture through exchange membership, while permissible, was contrary to public policy.

The issues, therefore, are: (1) Was NASD membership legally permissible; and (2) was exchange membership for an affiliate contrary to public policy?

ARGUMENT

POINT I

THE DEFENDANTS WERE UNDER A DUTY TO RECAPTURE BROKERAGE COMMISSIONS FOR THE FUND, IF POSSIBLE.

The Court below properly held that the defendants were obliged to recapture brokerage commissions, if possible:

> "The principle is accepted that defendants were under a duty by all proper means to secure for Fund the return of excess brokerage commissions." (339a).

Accordingly, this point need not be belabored. We trust a brief outline of its foundations will suffice.

A. Defendants owed Fiduciary Duties to the Fund both under the Investment Company Act and the Common Law.

It is by now well settled that the Act imposes upon investment advisers to mutual funds, as well as upon their directors, the duties and obligations of fiduciaries. Rosenfeld v. Black, 445 F.2d 1337, 1345 (2d Cir. 1971); Aldred Inv. Trust v. SEC, 151 F.2d 254, 260 (1st Cir. 1945), cert. denied 326 U.S. 795; General Time Corp. v. American Investors Fund, 283 F. Supp. 400, 401 (S.D.N.Y. 1968), aff'd 403 F.2d 159 (2d Cir. 1968), cert. denied 393 U.S. 1026;

Brown v. Bullock, 194 F. Supp. 207, 218 (S.D.N.Y. 1951), aff'd 294 F. 2d 415 (2d Cir. 1961).

If recapture was possible - as we shall show it was (pp. 25-50 infra) - and if the management defendants knew of that possibility - as they did - the fiduciary duties of the management defendants were two-fold. At the least they were obliged to inform the independent directors so that those directors could reach an indepen[illegible]nt decision whether or not to pursue recapture. In the present case, moreover, defendants' duty went further: under the charter of the Fund they were required to pursue all available recapture possibilities.

The Management Co. defendants were fully cognizant of the possibility of recapture. They became aware of recapture practices of other funds as early as 1965 (231a, 240a). They read and considered the recapture urgings of the SEC in its 1966 PPI Report (82a, 97a, 227a). They also read and considered the SEC's proposed rule 10b-10 which directed recapture of give-ups by all registered investment companies (233a-236a). Mr. Chestnutt testified that he was aware of NASD recapture:

> "Q. You say you don't know of any way that could be done [recapture]. So that you believe...
>
> A. No directly. You could do it [recapture] by devious methods as were described earlier, becoming an NASD member and directing business to your subsidiary who is a member or some devious way like that. But not directly." (238a; interpolation added)

Yet, the Management Co. defendants and counsel, Messrs. Sabel and Lee, advised the unaffiliated directors that recapture for the Fund was impossible (30a, 268a-272a).*

Those who were supposed to act as counselors to the Fund's unaffiliated directors had a distinct interest in avoiding recapture. Messrs. Sabel and Lee, counsel to the Fund and its directors, had a substantial financial stake in the Management Co. and were directors thereof (supra, pp. 5-7).

The disinterested directors believed the "advice" they were given by Messrs. Sabel and Lee (108a-110a, 118a-121a, 249a, 321a). They were, by and large, unfamiliar with the securities brokerage industry (173a). They never sought outside advice (121a, 246a-248a, 321a). And they never knew that recapture was available without substantially changing the operations of the Fund or Management Co. Had they known this fact they might have favored recapture (120a, 121a).

In Moses v. Burgin, 445 F. 2d 369 (1st Cir. 1971), cert. denied sub nom Johnson V. Moses, 404 U. S. 994, an almost identical situation arose. There the management

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* Apparently the subject was rather perfunctorily dismissed for a number of the directors could not recall its even being discussed. (Trial Transcript pp. 340, 380; Trial Exhibit 23, p. 23; Trial Exhibit Q, pp. 40-41)

company was alerted to the possibility of recapture, but failed to advise the unaffiliated directors of this possibility. The Court held that the management defendants were liable to the Fund for their failure to make such disclosure:

> "Whatever may be the duty of disclosure owed to ordinary corporate directors, we think the conclusion unavoidable that Management defendants were under a duty of full disclosure of information to these unaffiliated directors in every area where there was even a possible conflict of interest between their interests and the interests of the fund. This duty could not be put more clearly than was stated by the SEC in 1965.
>
> > 'The Investment Company Act's requirement as to unaffiliated directors, if its purposes are not to be subverted, carries with it the obligation on the part of the affiliated directors, and the investment adviser itself, to insure that unaffiliated directors are furnished with sufficient information so as to enable them to participate effectively in the management of the investment company.' Imperial Financial Services, Inc., CCH Fed. Sec. L. Rep. ¶ 77,287 at 82,464 (SEC 1965).
>
> Except where it may be fairly assumed that every unaffiliated director will have such knowledge, effective communication is called for. And, in testing that assumption, it must be borne in mind that they are not full time employees of the fund and it may be - as with Fund's unaffiliated directors - that neither their activities nor their experience are primarily connected with the special and often technical problems of fund operation. If management does not keep these directors informed they will not be in a position to exercise the independent judgment that Congress clearly intended. The only question can be whether the matter is one that could be thought to be of possible significance." (445 F. 2d at p. 376-377)

B. The Fund's Certificate of Incorporation Required Recapture, if Possible.

The Certificate of Incorporation of the Fund provided in ¶ 3(c)(iv) that:

> "The public offering price of each share of capital stock shall be the net asset value then in effect plus the load or commission charged adjusted to the nearest full cent. Any load or commission for the distribution of shares of the Corporation by a distributor may be fixed from time to time by the By-laws of the Corporation, but shall in no event exceed 8-1/2% of the public offering price, <u>nor shall the consideration per share to be received by the Corporation after deduction of such loan or commission be less than the net asset value</u> ..." (Emphasis supplied) (Supplement to Appendix, below, p. 351a)

This provision clearly forbade the Fund to sell its shares at a price which would yield to the Fund less than the net asset value of the shares.

Under the By-laws, the Fund's shares were sold without any sales charge or load. This arrangement obviously did not affect or impair the right of the Fund to receive 100% of the net asset value of its shares. Suppose, however, that in order to provide for sales stimulation, the Fund had paid brokers who assisted in the sale of Fund shares, out of its treasury, an extra $2. for every $100 worth of shares they assisted in selling. Those extra two dollars would have been a "commission" within the provision of the Certificate. This

would have reduced the net price of the Fund, after commissions, to 98% of the asset value of the shares. Such an arrangement would have clearly violated the Certificate, since the clear intent of this provision was to protect existing Fund shareholders from having their Fund assets diminished in the race to acquire new shareholders. The payment of give-ups and reciprocals, coupled with the failure to effect recapture, had precisely the same effect.

In Moses v. Burgin, supra, a similar provision was involved. There the Charter read:

> "in no event shall any shares of Capital Stock of the corporation be issued or sold for a consideration (which shall be net to the corporation after underwriting discounts or commissions) less in amount or value than the net asset value of the shares so issued or sold,****" (Record on Appeal in Moses, p. 5452)

The Court of Appeals held in Moses v. Burgin:

> "If Fund receives the asset value of any shares, but at the same time rewards the selling broker with give-ups that it has a right to recapture for itself, then the net income Fund receives from the process of selling a share is less than asset value. The existing shareholders have contributed -- by paying more than otherwise necessary on Fund's portfolio transactions -- to the cost of the sale, which was supposed to have been borne by the new member alone." (Moses v. Burgin, 445 F. 2d 369, 374, supra)

The Court in Moses v. Burgin found that the Charter was violated if the Fund's directors failed to utilize all available recapture opportunities. The Court concluded:

> "...Management's implication, which in oral argument it emphasized to the point of affirmation, was that, if recapture was in fact practical, the directors still had a right to choose between recapture of the give-ups for Fund's direct benefit, and awarding them to brokers for its indirect benefit. We hold, however, that if recovery was freely available to Fund, the directors had no such choice." (445 F. 2d at 374)

POINT II

SUBSTANTIAL AMOUNTS OF THE FUND'S BROKERAGE COMMISSIONS WERE RECAPTURABLE.

As noted, two principal avenues for the recapture of brokerage commissions were available to the Fund: (A) membership in the NASD and (B) membership on the PBW Stock Exchange. Neither avenue would have involved either the Fund or Management in any activities in which it was not already engaged; nor would it have been in violation of law or public policy. Each offered opportunities to recapture substantial amounts of brokerage commissions. The availability of either method requires a reversal. We shall show that both avenues were open.

A. Recapture through NASD Membership

The National Association of Securities Dealers, Inc. ("NASD") is a self-regulatory organization established pursuant to § 15A of the Securities Exchange Act of 1934, 15 USC § 78o-3. As will be seen below, membership in the NASD makes available the recapture of large sums of brokerage commissions merely for the asking.

The NASD By-laws provide in Article I, § 1 for the admission of members as follows:

> "Any broker or dealer authorized to transact and whose course of business consists in actually transacting any branch of the investment banking or securities business in the United States, under the laws of any State and/or the laws of the United States, shall be eligible to membership in the Corporation, except such brokers or dealers as are excluded pursuant to Section 2 of this Article." (210a)

The excluded brokers and dealers referred to in § 2 are ones who have been suspended, expelled, convicted of certain crimes, or are financially irresponsible, etc.

The term "broker" as used in ARTICLE I, § 1 is defined in ARTICLE I, § 3 as follows:

> "The term "broker" means any individual, corporation, partnership, association, joint stock company, business trust,

> unincorporated organization or other legal entity engaged in the business of effecting transactions in securities for the account of others, but does not include a bank." (212a)

Similarly, the term "investment banking or securities business" is defined in ARTICLE I, § 3 as follows:

> "The term 'investment banking or securities business' means the business, carried on by a broker or dealer, of underwriting or distributing issues of securities, or of purchasing securities and offering the same for sale as a dealer therein, or of purchasing and selling securities upon the order and for the account of others; provided, however, that the term 'investment banking or securities business' shall not include transactions on regularly organized exchanges, but such term shall include all business relating to such transactions to the extent that such business is not conducted by a member of such exchange, or by any person or organization having the privilege of any such exchange for itself or any of its partners or executive officers." (213a)

Thus, a broker is defined as an entity engaged in the business of effecting securities transactions for the account of others, and a broker transacts a branch of the investment banking or securities business if he purchases and sells securities upon the order and for the account of others.

As seen above (p. 12), portfolio transactions were effected for the Fund which generated commissions of millions of dollars per year. Orders for these transactions

and for transactions of others (i.e., other advisory accounts managed by Management Co.) were placed by Messrs. Chestnutt and Greene, officers of the Management Co., assisted by other personnel of Management Co. (80a, 81a; Trial Exhibit 26, pp. 12-15). Messrs. Chestnutt and Greene frequently negotiated transactions for the Fund in the third market (73a, 74a, 89a-91a). They kept records of all transactions (106a-108a). In short, they performed all of the ordinary functions of a broker. Indeed, Greene testified that he had already passed the NASD exam and was registered as a broker-dealer with the State of Connecticut (103a, 104a).

In placing orders, negotiating transactions and keeping records, the Management Co. defendants clearly "effected transactions" for the Fund; indeed, defendant Greene admitted three times that he did "effect transactions" for the Fund and others (88a, 89a, 104a, 105a). It is thus perfectly clear that, if a subsidiary of the Management Co. or the Fund had been organized with the same individuals as officers, the subsidiary could have performed the same activities previously performed by those individuals for the Fund and the Management Co. In that case the subsidiary would have been purchasing and selling securities for the account of the Fund and others. The subsidiary would thus have fallen squarely within the requirements of the NASD By-laws; it could easily have qualified for membership and joined the NASD upon the payment of the nominal NASD membership

charge (Trial Exhibit 21, pp. 1083-84).

The Court below ignored the substantial brokerage activities which would have been performed by the subsidiary and thus regarded the proposed NASD member as an entity which would do no more than act as a conduit for recaptured commissions (338a). The Court overlooked the placing of orders, negotiation of transactions and maintaining of records which already figured prominently in defendants' activities and which would have been the principal functions of the subsidiary.

However, even in the absence of substantial brokerage activities, the evidence clearly shows that the Management Co. would have been granted NASD membership. Lloyd Derrickson, Senior Vice President and General Counsel of the NASD since 1962 (188a), was called to testify. Mr. Derrickson was, of course, familiar with the NASD membership requirements (189a). He testified that the NASD had "a free entry policy" (191a), that an applicant for membership need not execute transactions (id.), that a member of the NASD need not do business with the general public (192a), that an applicant would be admitted to membership even if doing no business (201a), and that he believed there were some "NASD members whose sole function was the receipt of give-ups" (206a). Mr. Derrickson concluded his testimony as follows:

"Q. Mr. Derrickson, if you had received an application from anyone saying that they wanted to become a member of the NASD for the sole purpose of receiving give-ups and crediting those give-ups against advisory fees charged by such applicant to a fund that it was advising, would the NASD have refused that applicaton?

MR. LEE: Objection to the form of the question.

THE WITNESS: No, I don't think we would have refused it." (208a)

Thus, it is clear that affiliates of mutual funds with far remoter connections to the execution of transactions than Management Co. or the proposed subsidiary could have obtained membership in the NASD, and, a fortiori, Management Co. or a subsidiary thereof or of the Fund could easily have done so. Nothing about Mr. Derrickson's testimony is "puzzling" or "not clear", the Court below to the contrary notwithstanding (339a).

The District Court held that the granting of membership "would have been an administrative failure of NASD" (id.). This finding overlooked that a subsidiary of the Management Co. or of the Fund could squarely meet the requirements of the NASD By-laws. In any event, it was not the function of the District Court to act as the guardian of the NASD By-laws in the context of this litigation. On the contrary, it should have followed the NASD's interpretation of its own membership requirements.

It is elementary that the interpretation of an administrative regulation by the agency issuing it has "controlling weight unless it is plainly erroneous or inconsistent with the regulation"; Udall v. Tallman, 380 U.S. 1, 16-17 (1965); Perrine v. William Norton & Co., 509 F. 2d 114, 120 (2d Cir. 1974). The NASD had adopted its membership rules as part of the self-regulation authorized by § 15A of the Securities Exchange Act; cf. Silver v. New York Stock Exchange, 373 U.S. 341, 352-3 (1963). The interpretation by this regulatory agency of its own rules is entitled to no less credit than the interpretation of any administrative rule by the agency adopting it. Such has, indeed, long been the law; Aronson v. McCormick, 13 Misc. 2d 1077, 1078, 178 N.Y.S. 2d 957, 959 (Sup. Ct. 1958), aff'd 6 App. Div. 2d 999, 177 N.Y.S. 2d 1004 (1958):

> "The Exchange defendant has established rules and regulations. Its officers and committees apply those rules and regulations. This court cannot under the circumstances here revealed substitute its own view (even if so inclined) for that of the Exchange's own officers."

Indeed, in Moses v. Burgin, 445 F. 2d 369 (1st Cir. 1971), cert. denied sub nom Johnson v. Moses, 404 U.S. 994, the First Circuit was faced with an almost identical problem. There the district court had held that exchange officials were erroneous in permitting recapture since, in the lower court's opinion, recapture violated the rules of those Exchanges.

The First Circuit reversed the District Court and held upon this point:

> "Whatever the terminology, the nature of the obligation imposed by such rules is to be determined primarily on the basis of the construction which the Exchanges that adopted the rules give to them. A court is not free to regard the problem as a statutory interpretation issue of first impression." (445 F. 2d at 382; footnote omitted.)

The NASD occupies the same status of a regulatory agency as the exchanges. Harwell v. Growth Programs, Inc., 451 F. 2d 240, 246-47 (5th Cir. 1971), modified 459 F. 2d 461 (5th Cir. 1972), cert. denied sub nom National Association of Securities Dealers Inc. v. Harwell, 409 U.S. 876. Accordingly, its construction of its own rules must be respected.

Judge Wyatt concluded his discussion of the availability of NASD membership by stating:

> "In any event, civil liability cannot be imposed for failure of defendants to do what it would have been deceptive and improper for them to do." (339a)

Defendants were never called upon to do anything "deceptive" or "improper". There would be no deception since NASD membership was available upon full disclosure of the truth. And if the NASD granted membership for the purpose of recapturing brokerage commissions, that would appear to be determinative of its propriety. Indeed, in Moses v. Burgin, 445 F. 2d 369 (1st Cir.

1971), cert. denied sub nom Johnson v. Moses, 404 U.S. 994, the Court held that NASD recapture was not only proper but mandatory.

Thus, returning excess brokerage commissions to the Fund would have been open and proper. But the Management Co. and the affiliated defendants arrogated to themselves the decision not to seek recapture. They preferred to use the excess brokerage commissions to further their own self-interest in promoting the sale of Fund shares. The use of commissions was accomplished by concealing the availability of recapture, of which they were aware, from the disinterested directors. It was thus the defendants' actual conduct which was deceptive and improper; and the District Court's holding that NASD membership was not available, short of deceipt and impropriety, is clearly erroneous.

The District Court conceded: "True, had there been an application, NASD might have accepted the application." (339a). This is quite an understatement, for, as we have shown, acceptance of a membership application was a virtual certainty. But even accepting, arguendo, the District Court's statement, liability necessarily follows.

The Management Co. and the affiliated defendants were fiduciaries. They had a duty to recapture brokerage commissions. Since there was a possibility of such recapture, they were

obliged to make the attempt. This they failed to do, and for such failure they must be held liable. Perlman v. Feldmann, 219 F. 2d 173, 176-77 (2d Cir. 1955), cert. denied 349 U.S. 952:

> "The corporate opportunity of whose misappropriation the minority stockholders complain need not have been an absolute certainty in order to support this action against Feldmann. If there were possibility of corporate gain, they are entitled to recover.
>
> "****
>
> "Only if defendants had been able to negate completely any possibility of gain by Newport could they have prevailed. It is true that a trial court finding states [that the evidence fails to show whether or not the expansion plan proposed by the plaintiffs would have been feasible and desirable.] This, however, cannot avail the defendants, who -- contrary to the ruling below -- had the burden of proof on this issue, since fiduciaries always have the burden of proof in establishing the fairness of their dealings with trust property. [Citations]. [Emphasis and interpolation added.]

Accord: Geddes v. Anaconda Copper Mining Co., 254 U.S. 590, 599 (1921); Pepper v. Litton, 308 U. S. 295, 306 (1939); In Re Las Colinas, Inc., 426 F. 2d 1005, 1013-14 (1st Cir. 1970); Pappas v. Moss, 393 F. 2d 865, 867 (3rd Cir. 1968); Gardner v. National Bulk Carriers, Inc., 310 F. 2d 284, 287 (4th Cir. 1962), cert. denied 372 U.S. 913 (1963); Meinhard v. Salmon, 249 N.Y. 458, 465, 164 N.E. 545 (1928).

Once the routine of obtaining NASD membership was accomplished, a number of methods for recapturing brokerage commissions would have become available. For present purposes it should suffice to set forth three which would have provided substantial recapture to the Fund.

1. <u>Give-ups through the PBW Exchange</u>

In 1965 the PBW Stock Exchange (then known as the Phildelphia-Baltimore-Washington Stock Exchange) adopted an amendment to Article XX of its Constitution permitting give-ups of 25% of the commissions on mutual fund orders to be directed to members of the NASD (48a-50a). In June 1966 the permissible give-ups to NASD members were raised to 40% (50a). Elkins Wetherill, President of the PBW Exchange, testified as follows:

> "Q. ...was it permissible for give-ups on commissions on transactions from mutal funds executed on the PBW Exchange to be paid to members of the NASD who were not members of the Exchange?
>
> A. Yes, that's correct.
>
> Q. So that if an order originated from a mutual fund, 40 per cent of the commission could be given to an NASD member, at least from November '65 to June '66, it was 25 per cent and from June '66 for two and a half years until December 1968, 40 per cent, is that correct?
>
> A. That's correct." (51a)

If the NASD member receiving the give-up was a mutual fund's investment adviser or an affiliate of such an investment adviser, it was permitted to pass the give-up on to the mutual fund by means of crediting the Fund's advisory fee with the amount of the give-up received. Mr. Wetherill testified:

> "Q. Now, if an NASD member who received such a give-up were an investment advisor of the mutual fund whose transaction was executed, would it be permissible under the constitution and rules of the exchange for such investment advisor to credit the amount of the give-up against the advisory fee owed it by the fund?
>
> A. Yes, it would.
>
> Q. Now, if the NASD member who received the give-up were instead of the advisor a subsidiary of the advisor, would the advisor be permitted to make such a credit?
>
> A. If the NASD member was a subsidiary of the advisor?
>
> Q. Yes, would the advisor be permitted to credit the advisory fees of the fund with the amount of the give-ups?
>
> A. There is nothing in our rules that says one way or the other what would happen to that. Our guidelines always were that if there was some contractual relationship, then there would be no reason why these profits couldn't be passed back." (51a, 52a)

Similarly, if the NASD member was a subsidiary of the Fund itself, the give-up could be received and passed on to the Fund in the form of a dividend or otherwise:

"Q. Now, apart from the investment advisor being a member of the NASD or forming a subsidiary to join the NASD, if the fund itself formed a subsidiary which became a member of the NASD, would it have been permissible under the rules of your exchange for the give-up to have been paid to that entity?

A. Yes, as long as it was a broker-dealer registered with the NASD.

Q. And if such a give-up were paid, would it be permissible under the constitution and rules of the exchange for the NASD member to pass the give-up to the parent fund in the form of a dividend?

A. Yes, with the same qualifications that I made before, that our rules said nothing about what happens to the profit of these broker-dealer subsidiaries and our guidelines say that as long as there was either a contractual relationship or they were passed back by means of dividends that we would find no objection to that." (52a, 53a)

Accordingly, give-up recapture was available to NASD members on the PBW Stock Exchange from 1965 until the abolition of give-ups in December 1968.

2. <u>Give-ups and discounts through the Pacific Coast Stock Exchange.</u>

The Pacific Coast Stock Exchange also provided for give-ups to NASD members who applied for so-called "approved non-member status" by filing a simple one page application form and paying a $100 fee (219a, 220a).* Moreover, in

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* An "approved non-member" was simply an NASD member who registered with the Exchange for the purpose of receiving give-ups or discounts (216a).

addition to such give-ups, the Pacific Coast Stock Exchange also permitted discounts to approved non-members (218a). Both the give-ups and the discounts were 25% of the commissions. But, unlike give-ups which were abolished in December 1968, discounts have continued right up to the present (id.).

Both the discounts and the give-ups received by the NASD members could have been recaptured. Mr. Thomas P. Phelan, President of the Pacific Coast Stock Exchange since 1961, testified as follows:

> "Q. If an approved nonmember receives a -- strike that. If prior to December 1968, an approved nonmember had received a give-up, and the approved nonmember was an investment advisor of a mutual fund, would the Exchange have taken any action to preclude the approved nonmember from crediting the advisory fee of the mutual fund in an amount equivalent to the amount of the give-up?
>
> MR. LEE: Objection as to the form of that question. Purely hypothetical.
>
> MR. MEYER: You may answer.
>
> A. As I understand your question, we would not object.
>
> * * * * * * * * *
>
> Q. With respect to discounts, does the Exchange take the same position which you stated that they took before, with respect to give-ups? Namely, that they do not preclude an approved non-member who is an investment advisor of a mutual fund from crediting his advisory fee charged the mutual fund with an amount equivalent to the amount of discount?
>
> MR. LEE: Objection as to the form of question.

MR. MEYER: You may answer.

A. We don't have any objection." (218a, 220a)

3. Tender Offer Fees

In tender offers the purchasing party frequently offers to pay a fee to any NASD member (or Exchange member) named by the tenderor. A typical offer of this type is in evidence as Trial Exhibit 49. Defendants testified that the Fund did on occasion tender blocks of stock in response to tender offers (86a). Accordingly, it would have been a simple matter to designate the NASD affiliate as recipient of the tender fee and thereby recapture the fee for the Fund. Indeed, the SEC has stated that fund advisers have a duty to do just that. SEC Release No. 10102, CCH Fed. Sec. L. Rep. ¶ 79,327 (1973).

In sum, as the Court found in Moses v. Burgin, supra, (445 F. 2d 369), NASD recapture was readily available to the Fund. Its availability was attested to by the unrefuted testimony of three disinterested witnesses - the Senior Vice President and General Counsel of NASD, the President of the PBW Stock Exchange and the President of the Pacific Coast Stock Exchange. Their testimony was clearly in accordance with the constitution and rules of their respective agencies.

B. Recapture through PBW Stock Exchange Membership

Recapture was also available to the Fund through membership, by an affiliate of the Fund or of Management Co.,

as an "introducing broker" on the PBW Stock Exchange. An introducing broker is one who, having obtained the customer, places transaction orders with other brokers for execution and clearance. Such membership was available at all times, even after give-ups were outlawed in December 1968 (53a). It would not have offended any public policy, nor would it have required either the Fund or Management Co. to make any substantial alteration in its method of doing business.

Before discussing the evidence showing the availability of this type of recapture, it is important to distinguish the finding in Moses v. Burgin, supra, that the adviser there could not have become an introducing broker on the New York Stock Exchange (445 F. 2d at p. 375). That finding applied only to New York Stock Exchange membership. We do not contend that NYSE membership was available; PBW membership is a distinct matter, which was not considered by the Court in Moses.

The Court there found as follows:

> "Alternatively, plaintiff suggests that Crosby might become a more limited type of broker, on the New York Stock Exchange, known as an introducing broker. This itself would not have required substantial operational changes, in fact, plaintiff's suggestion is really that Crosby could become, under this label, a conduit for give-ups though not in any way engaged in normal brokerage activities. But the court found that NYSE required that all brokers, to be members, must be engaged

primarily in brokerage, and that in the application of this principle the exchange regarded the broker and its affiliate as one. It found that Management and Crosby, accordingly, would not have been able to qualify for membership (F. 56). Plaintiff has not successfully attacked this finding." 445 F. 2d at 375.

In short, the Court in Moses rejected the possibility of securing an "introducing membership" for Crosby, a subsidiary of the adviser, on the New York Stock Exchange for only one reason: The New York Stock Exchange, in passing upon applications for membership, requires that the principal business of the applicant and of its parent be that of a broker. Since the affiliate in Moses would have been a subsidiary of the adviser, its primary business, when combined with that of its parent, would have been investment advice rather than brokerage, and it would not have qualified.

Unlike the New York Stock Exchange, the PBW Stock Exchange did not and does not consider the business of an applicant's parent when passing upon the requirement that the applicant be primarily engaged in brokerage. Thus, a subsidiary of a fund or of its investment adviser could obtain so-called institutional membership on the PBW Exchange although unable to do so on the NYSE.*

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* The NASD does not require that the principal purpose of an NASD member be that of a broker.

Mr. Wetherill, president of the PBW Exchange, testified that a subsidiary of an investment adviser of a fund or of the fund could obtain exchange membership while doing no more than acting as an introducing broker - namely, simply transmitting orders to other brokerage firms for execution and clearance. The applicant need not even be a member of the NASD:

> "Q. Now, in order for a corporation to be deemed to have its principal corporate purpose as the transaction of business as a broker or dealer in securities, is it necessary for the corporation to actually execute the transactions?
>
> A. It is not necessary for the corporation to actually execute transactions, no, that is correct, but I think that the answer requires some amplification. Obviously it executes transactions in some way even though it doesn't do them itself. The corporation would not be a broker-dealer in securities if it couldn't execute buy and sell orders for customers even if the customer was its parent.
>
> Q. I am talking now about the mechanical execution. It needn't be on the floor of the exchange and execute?
>
> A. No, it need not.
>
> Q. Would it be necessary for the corporation, in order to qualify, to clear the transaction?
>
> A. Itself, no.
>
> Q. Would it be sufficient for the corporation to qualify as a broker or dealer if it acted as an introducing broker and transmitted brokerage orders to other members of the exchange for execution and clearance?
>
> A. There would be no objection to that.

Q. Would the corporation be disqualified from membership if it were the subsidiary of an investment adviser of a mutual fund?

A. No.

Q. Would your answer to that question be any different if the mutual fund were a no-load fund?

A. No different.

Q. Would the corporation be disqualified from membership if it was a subsidiary of the fund itself rather than the adviser?

A. No, it wouldn't.

Q. Would your answer be any different if the fund were a no-load fund?

A. No, my answer would be the same.

Q. Now, in determining whether a corporation's principal purpose is that of a broker or dealer, do you consider the corporation's business together with the business of its parent or other affiliates?

A. Not necessarily, no. The individual who is applying for membership and who is an officer of the corporation appears before our membership committee, and usually we require that he bring with him schematic diagrams of the whole corporate setup of the entities involved so that the admission committee has some background as to exactly who this member is that they are considering. But we are primarily looking at the member himself and the organization in which he is an officer. We reserve the right to inspect the books of any parent or to suspend from membership the member if the parent should become involved in practices which we think are not in the best interests of the exchange.

Q. But you are primarily concerned with the corporate applicant itself rather than the parent?

A. Exactly.

Q. And in this respect do you differ from the New York Stock Exchange?

A. Yes, right.

Q. The New York Stock Exchange --

A. -- has a parent rule which says that the parent must also be primarily in the brokerage business.

Q. and you do not?

A. No, we do not.

(54a-56a).

Q. Is it required that a member corporation have more than one customer?

A. No.

Q. Is there any requirement that a member deal with the general public?

A. No. I would like to qualify that because many times, in testifying in Congress, we have taken the position that a broker-dealer who is an affiliate of a mutual fund or an insurance company is, in effect, dealing with the public because he is transacting business for the thousands of shareholders in the mutual fund or policy holders of a mutual company. That is, in effect, doing a public business. We get into that argument of the 80-20 business, what is a public business. We claim that these brokers do do a public business.

(57a-58a).

Q. I want to ask you a hypothetical question, Mr. Wetherill, which is rather complex, so I warn you to listen carefully and if you have any difficulty with it I would be glad to re-read it to you or have the reporter read it back.

If a no-load mutual fund was effecting portfolio transactions which generated commissions in excess of $2,000,000 per year, and if that

> fund or the investment adviser of that fund formed a subsidiary which employed as officers a person or persons who had experience in placing orders for fund transactions, and if one of such employees had had prior experience with a securities firm known as First Boston Corporation* and had passed the NASD exam for registered representative, and it was stated that it was the intention that said subsidiary would continue to place orders for portfolio transactions of the fund as an introducing broker with other brokers and dealers, maintaining appropriate bookkeeping records, and if it were further stated that the fund was the only customer of the subsidiary and the purpose of exchange membership was to recapture brokerage commissions, would, in your opinion, such subsidiary have been eligible for membership on the PBW Exchange prior to the adoption of Rule 19b-2 earlier this year?
>
> MR. LEE: Objection.
>
> THE COURT: I will take it. Overruled.
>
> A. There are two other criteria that you didn't mention before this firm would have been eligible, and one is that it meets our capital requirements, and the other is that it is a member of the NASD.
>
> Q. What are your -- can you briefly state your capital requirements?
>
> A. The capital requirements, they were recently changed and now for an entering firm it must have $45,000.
>
> Q. And subject to those two qualifications, the answer would be that they would be admitted to membership?
>
> A. Yes.

(65a-66a).

After consulting with his counsel, Mr. Wetherill corrected his statement that NASD membership was required:

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* Greene so testified (103a).

"Q. Mr. Wetherill, have you conferred with counsel on the question of whether it is necessary to be a member of the NASD in order to be a member of the exchange?

A. Yes, I have. The answer is there is no requirement that a firm be a member of the NASD member organization ....

Q. And an institutional affiliate would not have to be a member of the NASD in order to join, is that correct?

A. No, it would not.

(171a-172a).

Once exchange membership was obtained, recapture of brokerage commissions was permissible. Mr. Wetherill testified:

"Q. Where a subsidiary of an investment adviser of a mutual fund is a member of the exchange, is it permissible under the constitution and rules of the exchange for the investment adviser to credit against the advisory fees of the funds profits received by the subsidiary?

A. Yes.

Q. Would your answer be any different if the fund in that question were a no-load fund?

A. No.

Q. Now, where the member is a subsidiary not of the investment adviser but of the mutual fund itself, would it be permissible under the constitution and rules of the exchange for that subsidiary to pass its profits to its parent mutual fund in the form of a dividend?

A. Yes, it would.

Q. And would your answer to that question be any different if the fund were a no-load fund?

A. No."

(62a-63a).

The advantages of PBW Exchange membership over NASD membership would have been threefold: in the first place, an introducing broker could retain a larger percentage of the commissions - "in the neighborhood of 80%" (60a); in the second place, members of PBW could obtain substantial brokerage business in return for business which the Fund placed with brokers on the NYSE (60a, 61a; Trial Exhibits 50 and 53); and in the third place, recapture through exchange membership was not at all dependent on give-ups and thus not affected by their abolition.

Mr. Wetherill testified that approximately 50 institutional affiliates, including at least one affiliate of a no-load fund, had obtained membership on the PBW Exchange, most of whom did so for the purpose of recapturing brokerage commissions. (70a).

Accordingly, the recapture of brokerage commissions through membership on the PBW Stock Exchange was readily available without any substantial alteration in the method of doing business of the Fund or Management Co. Indeed, the District Court did not find otherwise.

The Court below correctly found that membership on PBW did not require membership in NASD (340a). But the Court held such membership "would require defendants to pretend that

the new subsidiary was a broker, when in fact it was not, for the purpose of securing a preference over other investors by recapturing a part of the fixed commission." (Id.)

The Court below apparently assumed that an "introducing broker" is not a broker. There is simply no basis for this assumption.* It was for PBW to determine what it meant by "broker". If its interpretation of the term was broader than that of the district court, the PBW's definition was binding on the court.

Nor is the recapture of brokerage commissions a preference. As has been seen (pp. 17-18 , supra), recapture normally takes the form of a credit against advisory fees or an upstream dividend out of profits. In either case, the full minimum commissions are paid. Other investors could hardly complain about the reduction of an advisory fee to which they are not subject or to profits from a venture which they are also free to undertake. For these reasons, courts have given their express blessings to brokerage recapture; Moses v. Burgin, supra; Kurach v. Weissman, 49 F.R.D. 304 (S.D.N.Y. 1970); Weiss v. Chalker, 59 F.R.D. 533, 535 (S.D.N.Y. 1973.**

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* On the contrary, introducing brokers have received widespread recognition. See SEC Rel. No. 34-8746, CCH Fed. Sec. L. Rep. ¶ 77,761 at p. 83,747 (1969); The Financing of Sales of Mutual Fund Shares, 115 U. Pa. L. Rev. 769, 832-33 (1967).

**It may be noted that, even apart from recapture, numerous "preferences" have been available with respect to commission rates. Independent Broker-Dealers Trade Ass'n v. SEC, 442 F.
[footnote continued on next page]

While not disputing the availability of PBW memb -ship recapture, the District Court found it offensive to -blic policy:

> "While it may have been theoretically possible for PBW and the defendants, in collusion and for the selfish purposes of each, to accomplish such a result [membership recapture], it would have been contrary to public policy." (340a)

The Court relied on a 1973 SEC Release, accompanying a new rule, for its public policy finding. It did not specify any basis - and none there is - for indicating "collusion".

The Court below completely misconstrued applicable public policy in two respects.

1. Timing

Public policy is not static; it can and does change markedly over periods c. time. The time period covered by the present action is from January 1, 1965 to the present (328a)

At the beginning of that time period the public

** [footnote continued from previous page] 2d 132,136 (D.C. Cir. 1971), cert. denied, 404 U.S. 828; Thill Sec's Corp. v. New York Stock Exchange, 4/3 F. 2d 264, 274 (7th Cir. 1970), cert. denied 401 U.S. 994. Moreover, recapture benefits have been obtained by some of the most respectable mutual funds, including three of the largest fund groups. PPI pp. 172-173 (29a, 146a-147a).

policy considerations were very clear. As early as 1963, the SEC's "Special Study of Securities Markets" severely criticized reciprocals and give-ups because they create a conflict of interests between the fund and its adviser:

> "The reciprocal give-up also produces a conflict of interest ... here the conflict exists between the interests of fund shareholders in lower commission charges and the interests of mutual fund advisers and underwriters in stimulating the sale of additional shares through directing a split in commission charges." Report of Special Study of Securities Markets of the Securities and Exchange Commission, Pt. 2, p. 318 (House Doc. No. 95, Pt. 2, 88th Cong. 1st Sess. (1963).

See also Pt. 4 of the Special Study at pages 213-235.

The conflict of interests disappears, of course, if give-ups and reciprocals are recaptured by the fund. The Special Study concluded:

> "Mutual fund directors and those who transact portfolio business for them are primarily obligated to obtain the best available terms in such transactions for the benefit of fund shareholders without regard to the reciprocal business aspects of the transactions, and to see that the funds themselves receive the maximum benefits available from any such reciprocal business." Special Study, Pt. 4, p. 235.

In 1965, large mutual fund complexes obtained memberships on the Pacific Coast Stock Exchange for the purpose of recapturing brokerage commissions (29a, 140a-147a). In 1966, the SEC's PPI Report called attention to such membership

recapture. The SEC urged widespread emulation by other institutional investors of membership recapture. Id., pp. 16, 172-73 (141a, 146a-147a):

> "Widespread emulation by institional investors of the precedent set by these four complexes could have a marked effect on the economics of the securities industry. Within the framework of the existing commission rate structure, it is a method whereby mutual fund shareholders can derive greater benefits than they have heretofore received from fund brokerage commissions..."

At the same time the SEC severely criticized reciprocals and give-ups which were used to promote sales of fund shares. Id., pp. 15-17, 167-82.

In 1968, the SEC reaffirmed its policy position in Release No. 34-8239 (252a et seq.). In that Release, the Commission again criticized reciprocal and give-up practices used to promote sales. It discussed approvingly the practice of membership recapture (255a) and concluded:

> "...[I]f, as pointed out above, a mutual fund manager has various means at his disposal to recapture for the benefit of the fund a portion of the commissions paid by the fund, he is under a fiduciary duty to do so." (259a)

In December 1970, the SEC again stated that investment advisers "were under a duty to act solely in the best interest of Fund and its shareholders...." The Commission found that a management company, with exchange membership, was obliged to

recapture commissions and thus "confer on Fund the benefits attributable to Fund's assets." Matter of Provident Management Corp., CCH Fed. Sec. L. Rep. ¶ 77,937, at pp. 80,086-7 (1970).

In August 1971 the SEC filed an amicus brief in Gross v. Moses, 67 Civ. 4186 (S.D.N.Y.), again supporting membership recapture.

A change in the Commission's attitude became apparent when it adopted Rule 19b-2, 17 C.F.R. § 240.19b-2, effective March 15, 1973. One of the purposes of the Rule was to preclude membership recapture. As pointed out by the Senate Subcommittee on Securities:

> "This [Rule 19b-2] represents an unexplained alteration of the position taken by the SEC in several court cases involving the failure of mutual fund advisors to make use of membership to reduce commission charges paid by the funds they manage. See, e.g., Memorandum of the SEC as Amicus Curiae, Gross v. Moses, 67 Civ. 4186 U.S.D.C. S.D.N.Y. (August 1971). The SEC took the position that where recapture of commissions is available through regional exchange membership, mutual fund managers must at least make a bona fide judgment as to whether to establish a brokerage affiliate to recapture commissions for the fund." (Report of the Senate Subcommittee on Securities, Committee on Banking, Housing and Urban Affairs, Senate Doc. No. 93-13, 93rd Cong. 1st Sess. p. 84 n. 111 (1973); 297a).

Notwithstanding the adoption of Rule 19b-2, the SEC suspended its application as to institutional affiliates which had, prior to 1973, become exchange members. SEC Rel. No.

34-10052, CCH Fed. Sec. L. Rep. ¶ 79,304 (1973); SEC. Rel. No. 34-10934, CCH Fed. Sec. L. Rep. ¶ 79,912 (1974).* Thus, as of the present time, the SEC permits the continuation of membership recapture by institutional members.

Exchange membership in the present case could have and should have been obtained prior to 1973. Had such membership been obtained, the Fund would be recapturing commissions up to the present by virtue of the suspension of the application of Rule 19b-2.

On May 1, 1975, all exchanges will be prohibited from enforcing fixed commission rate schedules (SEC Rel. No. 34-11203 (January 23, 1975)). With the abolition of fixed commissions, of course, membership recapture will no longer be necessary, because the Fund will be able to negotiate low commissions which reflect no more than the fair cost of the brokerage services provided.

2. Congress and the Courts

Public policy is not the sole province of the Securities and Exchange Commission. The Congress and the courts have also spoken on the desirability of membership recapture.

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* A judicial stay of the Rule was also obtained by the PBW Exchange (64a).

In April 1973, the Senate Subcommittee on Securities of the Committee of Banking, Housing and Urban Affairs issued its Report, supra. The Senate Subcommittee was critical both of the SEC's Rule 19b-2 and of the exchanges' fixed commission rates (pp. 43-51, 83-84). The Subcommittee concluded:

> "So long as commissions continue to be fixed on institutional-sized transactions, it does not seem appropriate to eliminate current efforts by financial institutions to recapture excessive commission costs exacted from their beneficiaries." (p. 87; 300a)

As seen above, the courts have consistently held in favor of recapture. In Kurach v. Weissman, supra, 49 F.R.D. 304 (S.D.N.Y. 1970), a stockholder's action on behalf of the Dreyfus Fund was settled with court approval by permitting the Fund to recapture its brokerage commissions and give-ups through exchange membership by an affiliate. The same is true of Weiss v. Chalker, supra, 59 F.R.D. 533, 535 (S.D.N.Y. 1973), and numerous other settlements which have not been officially reported. These judicial approvals of recapture all adhere to the admonition of the First Circuit in Moses v. Burgin, 445 F. 2d 369 (1971), cert. denied sub nom Johnson v. Moses, 404 U.S. 994, that defendants have a duty to recapture where it is possible to do so. The Court below expressed some doubt as to whether Moses v. Burgin was rightly decided and believed that it had not been applied in this circuit (341a). However, this Court cited Moses v. Burgin with approval in its decision in Papilsky v. Berndt, 466 F. 2d

251, 254 n.3 (2d Cir. 1972), cert. denied 409 U.S. 1077; and in Frankel v. Hyde, CCH Fed. Sec. L. Rep. ¶ 94,486 (S.D.N.Y. 1974, Conner, J.), the Court expressly followed Moses as standing "unequivocally for the principle that in the proper circumstances, not only is recapture an acceptable form of reducing the Fund's expenses, but the unjustified failure of those in control of the Fund to insist upon recapture creates a cause of action under Section 36(b) of the Act." (at p. 95,712).

Accordingly, public policy supports rather than opposes the use of exchange membership for recapture of brokerage commissions. Even granting defendants the most favorable interpretation of the SEC's views, it is clear that the Commission strongly favored membership recapture for the vast majority of the period in question here, and Congress and the courts have done likewise.

Even if the duty to effect membership recapture were less clear, the question was not one which the Management Co. defendants were free to decide on their own. The affiliated directors, at a minimum, owed the disinterested directors the obligation of allowing them to pass upon the question. The disinterested directors were never given that opportunity because the Management Co. and its affiliates, although alerted to the availability of membership recapture, never informed the disinterested directors of the possibility of such recapture, or

indeed, of any other type of recapture. In fact, they did quite the opposite; they told them that the "possibility of recapture ... does not arise" for the Fund (30a, 268a-272a). In Moses v. Burgin, supra, the court held:

> "We therefore conclude that the management defendants were guilty of gross misconduct within the meaning of the Act in failing to disclose the possibility of NASD recapture to the unaffiliated directors. The two individual management defendants, and the Management corporations, must be held liable for damages under § 36." 445 F. 2d at 384.

Here, the defendants did not stop at non-disclosure, but affirmatively misrepresented. They must be held liable.

POINT III

THE FUND'S INVESTMENT ADVISORY AGREEMENT FORBADE THE USE OF RECIPROCAL BROKERAGE AND GIVE-UPS TO PROMOTE SALES OF FUND SHARES.

The Investment Advisory Contract between the Fund and Management Co. required Management Co., rather than the Fund, to bear all expenses of selling Fund shares:

> "7. The Investment Adviser shall .... pay all promotional, travel, and entertaining expenses relating to Fund Sales." (169a, 183a).

Thus, even if recapture of brokerage commissions were impossible, Management Co. would not be permitted to fulfill its obligations by using the Fund's brokerage commissions.

Management Co.'s patent breach of the Investment Advisory Contract had deleterious effects upon the Fund, which the above-quoted paragraph was presumably designed to avoid. As pointed out above (pp. 51-53), the use of reciprocal brokerage and give-ups has been severely criticized by the SEC because of the conflict of interests it creates. In the first place, if brokers are picked with an eye to their contribution to the sale of fund shares rather than their expertise in execution, the resulting improper executions will cause higher costs to the fund. (PPI pp. 185, et seq.). Secondly, the use of the fund's brokerage to generate give-ups and reciprocals for the benefit of the manager creates pressure for the unwarranted rapid turnover of portfolios. (PPI, p. 174).* And finally, the stimulation of the sale of fund shares leads to an undesirable growth in the size of the fund, which presents portfolio management problems (PPI, pp. 255, et seq.)** All of these difficulties could have been avoided if the Investment Advisory Contract had been adhered to.

Breach of the Investment Advisory Contract constitutes a violation, not only of common law, but also of the Investment

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* Indeed, Management Co. admits that its management of the Fund has "resulted in a higher than average rate of portfolio turnover" (160a, 176a), running to 81.9% in 1968, 71.1% in 1969, 93.1% in 1970 and 73.3% in 1971 (id.).

** For the five year period ended December 31, 1971 the Fund's portfolio performance ranked dead last of about 220 mutual funds covered by Fundscope Magazine (Trial Exhibit 52).

Company Act. Section 15(a) of the Act attaches particular significance to the Investment Advisory Contract by requiring precise description of the adviser's compensation and shareholder and director approval of the agreement. In Rosenfeld v. Black, supra, the Court held:

> "When Congress, in § 15(a), required shareholder approval of any new advisory contract, it must have meant an approval uninfluenced by any improper motivations on the part of the outgoing advisory fiduciary." (445 F.2d at p. 1345).

A fortiori, Congress must have meant the approval of an enforceable investment advisory contract, the terms of which were to be given their proper effect. Congress could hardly have thought to attach such significance to investment advisory agreements as to require precise description of compensation and directorial and shareholder approval, and yet be deemed to have permitted a breach of such a contract to go unremedied. Indeed, a precise description of compensation is impossible where reciprocal brokerage and give-ups are used, for they add to Management Co.'s compensation in a manner incapable of precise definition. On this basis the SEC has stated that reciprocals and give-ups constitute a violation of § 15(a)(1) of the Act (259a, n.7).

Since defendants' breach directly inured to their benefit, they are liable to the Fund for their profits even if it had been impossible for the Fund to recapture commissions. Irving Trust

Co. v. Deutsch, 73 F. 2d 121, 124 (2d Cir. 1934), cert. denied, 294 U.S. 709; Wilshire Oil Co. v. Riffe, 381 F. 2d 646, 650-52 (10th Cir. 1967), cert. denied 389 U.S. 822; Fleishhacker v. Blum, 109 F. 2d 543 (9th Cir. 1940), cert. denied, 311 U.S. 665. In Irving Trust, supra, this Court held:

> "If directors are permitted to justify their conduct on such a theory [that the corporation had no opportunity for gain], there will be a temptation to refrain from exerting their strongest efforts on behalf of the corporation, since, if it does not meet the obligations, an opportunity of profit will be open to them personally."

The District Court completely ignored plaintiffs' contention to this effect.

CONCLUSION

Mutual funds were brought under federal regulation precisely because the public's savings were invested in a medium which was subject to a dangerous conflict of interests - the profiteering of the managers at the expense of the shareholders. No case illustrates that conflict more aptly than this one.

It lay within the power of the Management Co. to recover for the Fund large portions of the commissions which the Fund paid for the execution of portfolio transactions. But the interest of the Management Co. recoiled at recapture. The

Management Co. benefited by using the Fund's commissions to stimulate sales of more Fund shares, thus increasing its advisory fees.

The Investment Company Act foresaw, in a general way, just such a conflict; it provided for a core of independent directors to protect investment companies against encroachments by their managers. But here that protection failed because the Management Co. misled the independent directors as to the possibilities for recovery of commissions. The Management Co. reaped the benefit.

The Court below erred egregiously in holding as a matter of law that NASD recapture was forbidden and that exchange recapture, although not forbidden, was contrary to public policy. If this Court finds for plaintiffs on either point, the decision below should be reversed, since defendants were under a duty to recapture and breached their duty. Indeed, even if recapture were impossible, the Fund would be entitled to recovery for breach of the Investment Advisory Contract.

Accordingly, we submit that the judgment be reversed and the case remanded for a determination of the damages and

profits to be recovered for the Fund.

Dated: New York, New York
April 8, 1975.

Respectfully submitted,

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WILLIAM E. HAUDEK,
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On the Brief.

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

ROSALIND FOGEL, et ano.,

Plaintiffs-Appellants,

versus

GEORGE A. CHESTNUTT, et al.,

Defendants-Appellees

SUPPLEMENT TO APPENDIX

Plf. Ex 13-a
6/13/73

RESTATED CERTIFICATE OF INCO[illegible]

of

AMERICAN INVESTORS FUND, INC.

Under Section 807 of the Business Corporation Law

THE UNDERSIGNED, being the President and Secretary of American Investors Fund, Inc., hereby restate, certify and set forth:

(1) The name of the corporation is AMERICAN INVESTORS FUND, INC.

(2) The Certificate of Incorporation was filed by the Department of State on April 22, 1957; and amended and Restated Certificates of Incorporation were filed by the Department of State on August 27, 1957; July 3, 1958; November 17, 1965; July 20, 1967; and July 19, 1968; respectively.

(3) The Certificate of Incorporation is amended and changed to effect an amendment and change authorized by the Business Corporation Law, namely to amend, as authorized by paragraph (14) of Section 801 of the Business Corporation Law, subdivision (b) of Article 3 of the Restated Certificate of Incorporation, being a provision otherwise specified in Section 801, relating to the business of the Corporation, its affairs and its rights or powers.

(4) The text of the Certificate of Incorporation, as amended heretofore, is hereby restated as further amended and changed to read as herein set forth in full.

CERTIFICATE OF INCORPORATION

of

AMERICAN INVESTORS FUND, INC.

Pursuant to Article Two of the Stock Corporation Law

1. The name of the proposed corporation is AMERICAN INVESTORS FUND, INC. (hereinafter called the "Corporation").

2. The purposes for which it is to be formed are as follows:

(a) To make, establish and maintain selected and diversified investments in corporate securities, to supervise and manage such investments, and in furtherance of the foregoing to purchase, acquire in any manner, invest in, receive, own, hold, pledge, hypothecate, dispose of, avail of, sell, or otherwise deal in or with all forms of full or partly paid securities or option covering securities (which term "securities" shall without limitation of the generality thereof be deemed to include any shares, stocks, notes, bonds debentures, obligations, warrants, scrip, rights, certificates, receipts or other instruments representing rights to receive, purchase or subscribe for the same or representing any other rights or interests therein or in any property or assets) in, of or made, created, or issued by any corporations, companies, associations, partnerships, trusts, governments, states, municipalities and other political divisions or subdivisions thereof whether domestic or foreign and whether or not the purposes, powers, character of business carried on, be similar to the purposes, powers character of business carried on by the Corporation, or whether or not any contingent or other liability against the Corporation may arise or exist in respect of the doing of any of the foregoing things; to exercise, while the holder or owner of any of the securities above referred to, all the rights, powers and privileges appertaining to the holding or ownership thereof to the same extent that an individual might or could do.

(b) To conduct researches and investigations in respect of securities, organizations, businesses and general business conditions, in the United States and elsewhere, to secure information pertinent to the investment and employment of the assets and funds of the Corporation, to procure any or all of the foregoing to be done by others as independent contractors, and to pay compensation therefor.

(c) To borrow or raise moneys for or assume liabilities in connection with any of the objects or purposes of the Corporation; from time to time to issue bonds, debentures, notes or other obligations, secured or unsecured, of the Corporation for moneys so borrowed, or in payment for property acquired, or for any of the other objects or purposes of the Corporation or in connection with its business; to assume or guarantee similar obligations of others in payment for property acquired or for any of the other objects or purposes of the Corporation and to secure such bonds, debentures, notes or other obligations by

mortgage or mortgages, or deed or deeds of trust, or pledge or other lien upon any or all of the property, assets, rights, privileges or franchises or the Corporation, acquired or to be acquired, and to pledge, sell or otherwise dispose of any or all of such bonds, debentures, notes or other obligations of the Corporation for its corporate purposes; provided, that no borrowing shall be made which at the time thereof causes the aggregate outstanding indebtedness of the Corporation to exceed 10% of its total assets taken at cost.

(d) To acquire, hold, dispose of, transfer, re-issue or cancel its own securities in any manner and to any extent now or hereafter permitted by the laws of the State of New York and by this Certificate of Incorporation, provided that shares of its own capital stock belonging to the Corporation shall not be voted upon directly or indirectly.

(e) To purchase, take on lease or in exchange, hire, or otherwise acquire, hold, own, possess, deal in, sell, convey, assign, mortgage, pledge or otherwise encumber any and all goods, merchandise, commodities and other property, real, personal and mixed of every kind and description, and rights, estates, interests, franchises, licenses and privileges in such property, real, personal or mixed, wheresoever situated or located.

(f) To do all and everything necessary or suitable and proper for the accomplishment of any of the purposes or the furtherance of any of the powers hereinbefore set forth, either alone or in association with other corporations, firms, or individuals, and to do every other act or acts, thing or things, incidental or appurtenant to or growing out of or connected with the aforesaid purposes, business or powers, or any part or parts thereof, provided the same be not inconsistent with the laws of the State of New York.

The purposes and powers specified in the foregoing clauses of this Article 2 shall, except as otherwise expressly provided, in nowise be limited or restricted by reference to or inference from the terms of any other clause of this or any other Article of this Certificate, but the purposes and powers specified in each of the clauses of this Article 2 shall be construed as independent purposes and powers, and the foregoing enumeration of specific powers shall not be held, and is not intended, to limit or restrict in any manner the powers of the Corporation but is in furtherance of and in addition to the general powers conferred upon corporations organized under the Stock Corporation Law of the State of New York.

3. The amount of the capital stock of the Corporation shall be Eight Million Dollars ($8,000,000.) consisting of 800,000,000 shares of Capital Stock (herein sometimes called "Common Stock") of the par value of $.01 per share. The Capital Stock shall be designated Capital Stock and the powers, preferences and rights and the qualifications, limitations or restrictions thereof, together with certain related provisions for the management of the business of the Corporation and the conduct of its affairs are as follows:

(a) Holders of the Common Stock shall have no preemptive or preferential rights in respect of or in connection with the issue and sale by the Corporation of additional shares of Common Stock, except that no offering of the Common Stock of the Corporation shall be made at less than its net asset value, as hereinafter defined, unless such stock shall be first offered pro rata to the Common Stockholders of record of the Corporation.

(b) Each holder of record of the Capital Stock of the Corporation may demand redemption of the share or shares standing in his name by tendering the certificate or certificates for such share or shares together with such demand in writing to the Corporation for redemption. Except as provided below, and subject to there being legally available surplus funds out of which to pay the redemption price, the Corporation shall, within seven days following such demand and tender, pay to such holder the net asset value, as hereinafter defined, of such share or shares, such net asset value to be computed as of the close of business next following such tender for redemption. If the Board of Directors shall determine that it is in the best interests of the remaining stockholders of the Corporation, the Corporation may pay the redemption price in whole or in part by a distribution in kind, of securities from the portfolio of the Corporation, in lieu of cash, taking such securities at their appraised value employed for determining such redemption price, and selecting the securities in such manner as the Board of Directors may deem fair and equitable. The right of redemption may be suspended by the Board of Directors for any period during which the New York Stock Exchange is closed (other than customary weekend and holiday closings). It may also be suspended for any period during which trading on the New York Stock Exchange is restricted, during which an emergency exists as a result of which disposal by the Corporation of securities owned by the Corporation is not reasonably practicable, or it is not reasonably practicable for the Corporation fairly to determine the value of its net assets, each as determined by rules and regulations of the Securities and Exchange Commission, or for such other periods as the Securities and Exchange Commission may by order permit for the protection of holders of the Capital Stock. In order to expedite redemption of shares, the Board of Directors may make arrangements for the voluntary repurchase of shares.

(c) (i) For purposes of determining the net asset value of the Corporation's Capital Stock, the value of the total assets of the Corporation shall be determined at least once on each day on which the New York Stock Exchange is open for trading. The value of the assets of the Corporation may be determined at additional times if the Board of Directors consider such determination desirable.

(ii) For the purpose of valuing the assets of the Corporation, each security traded on the New York Stock Exchange or any other national securities exchange shall be taken at the most recent sale price prior to the time as of which the appraisal is made on the day when the appraisal is made. In each case where there has been no such sale and in the case of all other securities, the security shall be appraised at its last current quoted bid price, or at a price not exceeding any current

asked price representative of fair market value, where there is no such bid price or where such bid price does not appear representative of fair market value, all as may be determined by the Board of Directors or pursuant to their authority. No provision shall be made for odd lot premiums and brokerage commissions in computing the value of the assets of the Corporation. Cash shall be stated at its value, accounts receivable for dividends receivable and for investments sold and shares of Capital Stock sold shall be stated at the amounts to be received therefor as well as income receivable accrued daily on bonds and notes owned. Any other assets, and securities for which market quotations are not available, shall be stated at fair value as determined by the Board of Directors, except that no value shall be assigned to goodwill, furniture, lists, reports, statistics or other non-current assets other than real estate. Liabilities for accounts payable for investments purchased and for shares tendered for redemption and not then redeemed as to which the redemption price has been determined shall be stated at the amounts payable therefor, and accrued expenses and taxes shall be stated at estimated amounts accrued daily. No accruals shall be made on taxes on unrealized appreciation of securities owned unless the Board of Directors shall otherwise determine. Dividends payable by the Corporation shall be deducted as of the close of business on the record date therefor.

(iii) The net assets of the Corporation shall be the difference between its total assets and its total liabilities, excluding capital stock and surplus, valued as described above, and the term "net asset value" of the Cpaital Stock shall mean the quotient of the net assets divided by the total number of shares of Capital Stock at the time outstanding, exclusive of treasury stock and shares tendered for redemption and not then redeemed as to which the redemption price has been determined, but including shares presented for repurchase and not then repurchased and shares tendered for redemption and not then redeemed as to which the redemption price has not been determined.

(iv) The redemption and repurchase price of each share of Capital Stock at any time shall be its applicable net asset value. The public offering price of each share of Capital Stock shall be the net asset value then in effect plus the load or commission charged adjusted to the nearest full cent. Any load or commission for the distribution of shares of the Corporation by a distributor may be fixed from time to time by the By-Laws of the Corporation, but shall in no event exceed 8 1/2% of the public offering price nor shall the consideration per share to be received by the Corporation, after deduction of any such load or commission be less than the net asset value, provided, however, that until so fixed by such a By-Law no sales load shall be charged on securities issued by the Corporation. Any fractions involved in the computation of net asset value per share or of the redemption, repurchase or public offering price shall be adjusted to the nearest full cent.

(d) Shares of stock of the Corproation that have been purchased, redeemed, or otherwise reacquired by the Corporation shall be cancelled upon reacquisiiton and restored to the status of authorized but unissued shares.

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4. The office of the Corporation shall be located in the Village of Larchmont, County of Westchester and State of New York, and the address within the State to which the Secretary of State shall mail a copy of process in any action or proceeding against the Corporation which may be served upon him is P. O. Box 132, in said Village of Larchmont, N. Y.

5. The duration of the Corporation shall be perpetual.

6. The number of Directors of the Corporation shall be fixed from time to time by the By-Laws of the Corporation, but shall not be less than three (3) nor more than fifteen (15). No Director need be a stockholder of the Corporation.

7. The Secretary of State of the State of New York is designated as the agent of the Corporation upon whom process in any action or proceeding against it may be served.

8. Any securities owned by the Corporation or any of the funds or moneys thereof may be deposited with and held by a Custodian duly qualified to act as such under the Investment Company Act of 1940, under terms and conditions complying with the said Act and any rules and regulations duly promulgated thereunder.

9. The Corporation may enter into a written contract with any person (which term includes any firm, corporation, trust or association) therein elsewhere called the "Investment Adviser", to act as investment adviser of the Corporation; from time to time to make recommendations to the Board of Directors as to changes in, or additions to, investments of the Corporation and to prepare and submit from time to time analyses and to furnish reports as requested by the Board of Directors with respect to the investments or proposed investments of the Corporation; to furnish to the Corporation such office space as may be necessary for the suitable conduct of the Corporation's business and all necessary light, heat, telephone service, office equipment and stationery and stenographic, clerical, mailing and messenger service in connection with such office.

10. Anything contained elsewhere in this Certificate of Incorporation to the contrary notwithstanding, the Corporation may not and shall not:

(a) Buy corporate securities "on margin" except such short term credits as are necessary for the clearance of transactions;

(b) Effect "short sales" of corporate securities;

(c) Lend money or corporate securities to any person for any purpose whatsoever; provided, however, that the acquisition of bonds, debentures, notes and/or certificates representing any interest therein, provided they are corporate securities, shall not be held or construed to be the making of a loan;

(d) Invest more than five per cent of its gross assets in the securities of any one issuer, nor acquire or hold more than ten per cent of the outstanding securities of any one issuer; provided, however, that these limitations shall not apply to investments in obligations of the United States of America or to bonds, bills or notes guaranteed as to both principal and interest by the United States of America;

(e) Purchase or retain in its protfolio any securities issued by an issuer if at the time of or after such purchase any officer or director of the Corporation shall own beneficially more than one-half of one per cent of the shares or securities or both of such issuer, or if the officers and directors of the Corporation owning such shares or securities shall together own beneficially more than five per cent thereof;

(f) Invest any of its assets in the securities of any investment trust or of any other investment company except by the purchase thereof in the open market where to the best information of the Corporation no commission or profit to a sponsor or dealer results from such purchase other than the customary broker's commission;

(g) Invest any part of its assets in the securities of any company which shall have a record of less than three years continuous operation if such purchase at the time thereof would cause more than five per cent of its gross assets to be invested in the securities of such company or companies; provided that such period of three years may include the operation of any predecessor company, partnership or individual enterprise if the company in whose securities the assets of the Corporation are invested has come into existence as the result of a merger, consolidation or reorganization or the purchase of substantially all of the assets of such predecessor company, partnership or individual enterprise;

(h) Underwrite or participate in any underwriting of securities.

11. (a) The officers or directors of the Corporation or the Investment Adviser shall not deal with themselves for or on behalf of the Corporation as principal or agent or with any corporation or partnership in which they have a financial interest, except that

(i) The officers or directors of the Corporation are not prohibited from having a financial interest in the Investment Adviser or any distributor;

(ii) The purchase or sale of securities for the Corporation through an affiliated security dealer is not prohibited, provided the transactions are handled as broker only and provided the commissions charged are not more than customary; and

(iii) The Corporation may employ legal counsel or transfer agent, a dividend disbursing agent or a custodian who is, or which has a partner, officer or director who is, an officer or director of the Corporation, provided only customary fees are charged for the services rendered.

(b) The Corporation, the Investment Adviser, any distributor of securities of the Corporation and the officers and directors of any of them shall not take long or short positions in the securities of the Corporation, except that

(i) The distributor may place orders with the Corporation for its shares equivalent to orders received by it;

(ii) The distributor may maintain a market for the shares of the Corporation as agent for the Corporation; and

(iii) The officers and directors of the distributor, Investment Adviser and the Corporation may buy for investment shares of the Corporation at the public offering price.

12. The Board of Directors shall have power, by resolution passed by a majority of the entire Board of Directors as then constituted, to designate from their number three or more to constitute an Executive Committee, which shall for the time being, in the intervals between meetings of the Board of Directors, and to the extent authorized by law and by the By-Laws of the Corporation and/or by like resolution of the Board of Directors, exercise the powers and rights of the Board of Directors in the management of the affairs and business of the Corporation. Whenever in this Certificate of Incorporation it is provided that any action may be taken or omitted by the Board of Directors, the term "Board of Directors" shall be deemed to mean the Board of Directors or the duly authorized Executive Committee thereof designated as herein provided. By like resolution the Board of Directors may designate one or more other committees, each of which may consist of three or more members, and may be composed of Directors of the Corporation or persons not Directors or stockholders of the Corporation, to serve in an advisory capacity to the Board of Directors and its Executive Committee, and/or in such other capacities as shall be permitted by law and provided and authorized by the By-Laws of the Corporation and/or by like resolution of the Board of Directors.

13. The Corporation reserves the right to take any lawful action and to make any amendment of this Certificate of Incorporation, including the right to make any amendment which changes the terms of any shares of the Corporation of any class now or hereafter authorized by classification, reclassification or otherwise, and to make any amendment of this Certificate of Incorporation in any form, manner or substance now or hereafter authorized or permitted by law. Nothing contained in this subdivision shall be deemed to limit or restrict the Corporation in the full and proper use and enjoyment of its purposes, objects and powers, or otherwise, as now or hereafter set forth in this Certificate of Incorporation or any amendment hereof hereafter in force, or as now or hereafter authorized or permitted by law. All holders of shares of the Corporation by acceptance of the certificate or certificates representing their shares agree that all rights to which such shares entitle them are subject to the foregoing provisions of this subdivision and all other provisions of this Certificate of Incorporation from the time of the issuance thereof.

14. Each Director, officer and employee of the Corporation shall be indemnified by the Corporation against reasonable expenses, including attorneys' fees, actually and necessarily incurred by him in connection with the defense of any action, suit or proceeding, or in connection with any appeal therein, or a court approved settlement, to which he is made a party by reason of his being, or having been a Director, officer or employee of the Corporation, except in relation to matters as to which he shall be adjudged in such action, suit or proceeding to be liable for negligence or misconduct in the performance of his duties as such director, officer or employee; such indemnification shall not, however, protect any director or officer of the Corporation against any liability to the Corporation or to its security holders to which he would otherwise be subject by reason of negligence or misconduct in the performance of his duty. Such right of indemnification shall not be deemed exclusive of any other rights to which he may be entitled apart from statute. No payment pursuant to the foregoing shall be made to a director, officer or employee who is a party to a court approved settlement unless pursuant to the terms of such settlement.

(6) The restatement of the Certificate of Incorporation was authorized as amended heretofore and as further amended in paragraph (3) above, as authorized by the Business Corporation Law, by the affirmative vote of the holders of a majority of all outstanding shares entitled to vote thereon at a meeting of shareholders of the Corporation duly called and held on January 8, 1969, a quorum being present.

IN WITNESS WHEREOF, this certificate has been signed this 8th day of January, 1969.

George A. Chestnutt Jr.
President

S. Sabel
Secretary

STATE OF CONNECTICUT)
) SS:
COUNTY OF FAIRFIELD)

S. L. Sabel, being duly sworn, deposes and says that he is Secretary of American Investors Fund, Inc., the corporation mentioned and described in the foregoing instrument; that he has read and signed the same and that the statements contained therein are true.

S. Sabel

Sworn to before me this 8th day of January, 1969.

Katharine T. Oliver
Notary Public

KATHARINE T. OLIVER
NOTARY PUBLIC
MY COMMISSION EXPIRES MARCH 31, 1972

State of New York
DEPARTMENT OF STATE } ss.:

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I Certify That I have compared the preceding copy with the original Restated Certificate of Incorporation of

AMERICAN INVESTORS FUND, INC.,

filed in this department on the 8th day of January ,1969, and that such copy is a correct transcript therefrom and of the whole of such original.

Witness my hand and the official seal of the Department of State at the City of Albany, this eighth day of January one thousand nine hundred sixty-nine.

John P. Lomenzo

Secretary of State

D-504

Service of Two ~~three~~ ~~(3)~~ (2) copies of the within
is admitted this 8 day of APRIL 1975

Rogers & Wells

Attorneys for defendant
American Investors Fund, Inc.

Service of Two ~~three~~ ~~(3)~~ (2) copies of the within
is admitted this 8 day of April 1975

Rogers Hoge & Hills

Attorneys for Chestnutt
et al.